Making Sense of Finance

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Fourth Quarter 2018 Review

STOCK MARKET

Stock market returns in the fourth quarter were diametrically opposed to that of the third quarter. As mentioned in the previous newsletter, the old adage of “Sell in May” did not happen in 2018. In the aggregate investors did sell in October however, and continued the selling into December at a frenzied pace. The S & P 500 index, after hitting a record high on Sept. 20th, declined 19.8%, which is in the realm of being defined as a bear market. After reaching a near term bottom, the market rallied in the last few days of the year, but still ended the quarter with a 14% decline in the index, the worst quarter since the third quarter of 2011. Reviewing commentary from that period in 2011, it appears that there are the same old problems as in the past. Comments back in 2011 after that horrible quarter were “continued concerns about Europe”, “political and economic uncertainties in the U.S.” and “China may be facing its own set of economic problems” could just as easily have been said today as over seven years ago, and the market has more than doubled since then. (Not to say that the stock market will react in the same way this time, as we are further along in the business cycle). The S & P 500 index ended 2018 with a loss of 6%. Only four times since 1929 have there been back to back annual declines in the index. Other major indexes had similar declines last quarter. The widely followed Dow Jones Industrial index dropped over 11% and the Nasdaq Composite index, after leading on the upside earlier in the year, had a more significant decline in the fourth quarter with a loss of over 17%. Since the beginning of the year, however, the major indexes have recovered quite a bit of their losses. As of January 18th, in a few weeks period, the S & P 500 increased over 6% year to date! One of the bright spots last quarter was the amount of dividend increases. The average fourth quarter dividend increase in the S & P 500 index was over 10%. For all U.S. stocks, there were 787 dividend increases in the fourth quarter (and only 77 dividend decreases). Solid earnings permitted huge buybacks and hefty dividend increases.

Stock sectors unanimously declined in the fourth quarter, as the utility sector was the best performer with basically a flat return when dividends are included. Energy related stocks were the worst performers as the price of oil declined 38% in the fourth quarter. Technology stocks that had been among the best performing groups coming into last quarter retreated dramatically in the fourth quarter as profit takers came forward and general market weakness took over in the face of additional rate increases by the Federal Reserve. Industrial stocks that were also among the leaders in the previous

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Everyone and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 plus years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

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quarter also reversed course in the fourth quarter.

Foreign markets provided no place to hide in the fourth quarter or for that matter for all of 2018. The MSCI EAFE Index (developed market index) measured in US dollar terms declined over 12% in the last quarter and 16% for the year. All major foreign markets were in the red last quarter. The United Kingdom is set to leave the European Union in the near future which is contributing to anxieties in the European economies and markets. Amongst emerging markets, the Chinese stock market had one of the largest declines last quarter. Tariffs imposed by the United States as well as tariffs imposed by China may be contributing to negative economic consequences in their domestic economy. Indian and Brazilian stock markets were part of the small group of positive performers in the quarter.

BOND MARKET

Bonds for the most part fared well in the fourth quarter. The Barclays Bloomberg Aggregate Bond Index had a total return of 2% last quarter as investors fled equities for less risky assets, in particular Treasuries. U.S. Treasuries increased in price and were the best performing fixed income sector last quarter. The widely followed 10 Year Treasury yield decreased from 3.05% at the start of last quarter to 2.69% by the end of the year. This downward movement was favorable to mortgage rates as they too had a small decline. However, very short-term Treasury yields increased as the Federal Reserve raised the Fed Fund target rate again in December to 2.25-2.50%, the fourth increase in 2018. This caused the yield curve to slightly invert (longer rate lower than short term rate), as the year finished with the one-year Treasury yielding 2.63% and the 5-year Treasury yielding 2.51%. This inversion is not typical and many fixed income investors see this as slowing economic growth in the future. The rate hike in December and the statement made by Fed Chairman Powell at that time gave stock investors reason to fear more interest rate increases which in turn might cause the economy to slow down too much. Powell moderated his intentions in the first week of January, with his statement that the Federal Reserve is willing to be “patient” in regards to future rate hikes this year, and “willing to change course if necessary”. This temporarily seemed to satisfy both bond and stock investors.

Corporate bonds prices were flat to negative last quarter as investment grade and high yield spreads widened. The Bank of America High Yield Index which is composed of below investment grade bonds lost over 4% in the fourth quarter. Non-financial corporate debt to GDP ratio is at its highest level in over 70 years; companies took advantage of extremely low interest rates over last several years by issuing a large amount of debt. An inkling of a slowing economy may result in some of this debt to be downgraded in turn causing widening credit spreads. On a favorable note, municipal bonds and mortgage-backed debt had positive returns last quarter.

OUTLOOK

The word for 2018 was volatility. If you recall, we completely expected this given that 2017 oddly had very little volatility. While we were able to find some compelling investments in 2018, the minor stock market collapse in December produced many more candidates. Investors often forget that volatility is the intelligent investor’s friend. While others panic, the intelligent investor can find more bargains when others abandon perfectly good companies at fire-sale prices. This can also be advantageous when markets rise too quickly. The intelligent investor can avoid “flashes in the pan” and avoid trouble. In the short term, the intelligent investor usually looks “stupid” but having a contrarian view can also lead to long-term outperformance. This is what we aspire to do. A slowing of the economy could very well be in store for the USA, but this is not necessarily cause for gloom and doom; we just care if there will be a reacceleration at some point, and this is highly likely. As of January 18, the market was off to its best start since 1987, up 6% year to date, further proof the difficulty of trying to time the market.

We still see a lot of positive factors in the market; namely trillions of dollars that are on the side lines, strong share buybacks that will enhance earnings per share for stocks, and a hint that interest rate hikes will be slowing or even end in 2019. A lot of things can still go wrong, but the economy and corporate America have a number of levers it can pull to boost the economy and we are usually on the more optimistic side. With the bear stock market in December, valuations have come down considerably with strong economic growth present. Real estate prices in “hot markets” (Seattle, San Francisco, New York, etc.) continue to deflate, too. We much prefer this to a bubble that pops. We are much more optimistic about REITS (Real Estate Investment Trusts) because of this. Finally, bonds continue to hold their own, but we only think short-term duration bonds in the 5-year or shorter ranges are palatable.

Media noise such as the partial government shutdown, Brexit, and signs of a slowing economy are actually a positive. After all, we don’t live in a static world. If you see a semi-truck heading towards you, do you not try to step out of its way? It’s the individual that crosses the road without looking or ignores the traffic light that gets flattened. These warnings give corporate America reasons to make adjustments.

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